No. 10130

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

H. F. METCALF, as Trustee in Bankruptcy of the Estate of F. P. Newport Corporation, Ltd., a corporation, Bankrupt,

Appellee.

Brief for H. F. Metcalf, as Trustee in Bankruptcy of F. P. Newport Corporation, Ltd., a Bankrupt, Appellee.

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Opinion Below.

The District Court wrote no opinion in this case. The Court, however, adopted as its Findings of Fact and Conclusions of Law the Findings and Conclusions of the Referee in Bankruptcy. [R. 188, 189.] These Findings and Conclusions may be found at R. 28-41 and part of the Findings are hereinafter set forth in this brief.

Jurisdiction.

The jurisdiction of this Court to entertain the appeal of the United States is referred to in the Government's brief, and we see no occasion for repeating the sections therein mentioned.

Question Presented.

The question here involved as we see it is whether or not the Trustee in Bankruptcy in these proceedings, who has not been authorized to conduct the business which the Bankrupt Corporation engaged in prior to the filing of the petition in bankruptcy, is required to pay "income tax" on receipts resulting from transactions had by such Trustee in Bankruptcy in the performance of his normal duties pursuant to the provisions of the Bankruptcy Act.

Applicable Statute.

The answer to the foregoing question depends upon whether or not Mr. Metcalf, the Trustee in Bankruptcy, was operating the business or property of the corporation within the meaning of Section 52 (a) of the Internal Revenue Code. This statute is set out in full on page 3 of the Government's brief.

The Treasury Regulations referred to by the Government are not, we submit, of aid in arriving at an answer to the question hereinbefore mentioned. We shall hereinafter point out wherein such regulations are inapplicable.

Statement of Facts.

The facts were stipulated. [R. 50-60.] The Findings of the Referee which were adopted by the District Court are based upon the stipulation and the Government has attempted to summarize the same in its brief. This summary, however, is not in our opinion wholly accurate, and we therefore set out Findings 1 to 13, both inclusive, as follows:

"The Court finds that:

"1. The Commissioner of Internal Revenue determined deficiencies of $14,365.96 and $4,997.69 in the bankrupt's Federal income tax for the calendar years 1938 and 1939, respectively. Notice of the Commissioner's determination was sent to 'F. P. Newport Corporation, Ltd., H. F. Metcalf, Trustee in Bankruptcy, 216 Central Building, 108 West Sixth Street, Los Angeles, California' by registered mail on July 13, 1940. On July 22, 1940, Nat Rogan, as United States Collector of Internal Revenue for the Sixth Collection District of California, filed a claim in the above entitled bankruptcy proceeding on behalf of the United States for the sum of $19,363.65, representing the amount of alleged deficiencies in income tax so determined by the Commissioner of Internal Revenue for the taxable years 1938 and 1939. On September 28, 1940, the Trustee in Bankruptcy filed an objection in writing to the allowance of said claim.

"2. The bankrupt, F. P. Newport Corporation, Ltd., was organized under the laws of the State of Delaware on December 2, 1929, and it afterward qualified to do business in the State of California. It was engaged in the real estate business in the State of California prior to March 19, 1935. In the con-

duct of said business it purchased large tracts of unimproved lands, subdivided portions of them into city lots, installed the essential public improvements and then endeavored to sell the lots, and did sell a great many of them. It also acted as a selling agent for many parcels of real property owned by other persons. It conducted its business for the purpose of making a profit.

"3. On March 19, 1935, an involuntary petition in bankruptcy was filed against F. P. Newport Corporation, Ltd., in the United States District Court for the Southern District of California, Central Division, in case numbered 25,308-M, Bankruptcy. A receiver was thereupon appointed by the Court. All of the assets and affairs [33] of F. P. Newport Corporation, Ltd. were placed in the possession and control of said receiver. The receivership continued until January 12, 1937, when the corporation was adjudicated a bankrupt. H. F. Metcalf was appointed Trustee in Bankruptcy on March 18, 1937, and at all times since has been in possession and control of all the property and assets of the bankrupt.

"4. The properties and assets received from the bankrupt by said Trustee in Bankruptcy consisted of numerous parcels of real estate, both improved and unimproved, and other assets consisting of accounts, promissory notes, bills receivable and other tangible and intangible property.

"5. At the date of bankruptcy record legal title to approximately ninety per cent of the real properties received by the Trustee in Bankruptcy stood in the name of the Security-First National Bank of Los Angeles, in trust, as security for an indebtedness owing said bank by said F. P. Newport Corporation, Ltd., as evidenced by a written declaration of trust

numbered D-7224, formerly numbered SS-70401, signed by the bank, approved by the bankrupt, on March 1, 1930. At the date of filing the petition in bankruptcy said indebtedness exceeded $1,300,-000.00. Said bank filed a claim in the bankruptcy proceeding as an unsecured creditor in the amount of $500,000.00, after crediting what it determined to be the value of the security held by it upon the indebtedness of F. P. Newport Corporation, Ltd. Claims filed against the bankrupt estate other than the claim of said bank exceed in all the sum of $295,000.00, none of which have been paid by the Trustee in Bankruptcy, either in whole or in part.

"6. For the purpose of avoiding a forced sale of said real properties and with the object of obtaining time within which to liquidate the properties at a fair value, a contract was made and entered into by and between Security-First National Bank of Los Angeles, F. P. Newport Corporation, Ltd., the bankrupt, and the [34] Trustee in Bankruptcy with the approval of this Court. A copy of said agreement, with the supplements thereto and modifications thereof, is attached to said stipulation of facts, marked Exhibit 'A', and is by reference made a part hereof, as fully and completely as though here copied and set forth at length.

"7. Among the real properties title to which is so held by said bank under said declaration of trust are two parcels—one of three and the other of six acres, separated by an intervening three-acre parcel belonging to third persons. Both parcels are situated adjacent to what is known as Channel No. 3 of Long Beach Harbor in the City of Long Beach, California. During the pendency of the bankruptcy proceeding producing oil and gas wells were drilled and other wells were being drllied or about to be

drilled on nearby lands which adjoined and surrounded said two parcels. It was feared by the Trustee and said Security-First National Bank of Los Angeles that the operation of these wells would drain away the oil and gas believed by the Trustee to underlie the same. The Trustee in Bankruptcy did not have sufficient funds to enable him to drill any oil or gas wells. By and with the approval of this Court, he leased the said two parcels of land to Universal Consolidated Oil Company, a copy of which lease is attached to the Trustee's Petition for Authorization, Approval and Confirmation of an Oil and Gas Lease, and for Order to Show Cause, filed with the Court on January 14, 1938, reference to which is hereby made for further particulars, and the same is made a part hereof by said reference as fully and completely as though here copied and set forth at length. Other lots in the same general area which were not of sufficient size to be covered by separate leases, were included in a community oil and gas lease wherein the Bankline Oil Company was the lessee.

"8. Oil and gas royalties including bonuses actually paid to the Trustee under the terms and provisions of said leases during the year 1938 amounted to $245,517.65 and during the year 1939 amounted [35] to $206,333.36. These moneys were paid to the bank by the Trustee upon orders of this Court to cover taxes assessed against the properties, record legal title to which was so held by the bank as security for the indebtedness owing it, costs of engineering services for checking oil and gas production on the property leased to Universal Consolidated Oil Company, and to apply on account of the interest and principal owing on the secured debt of the said bank.

"9. From the sales of real estate made during 1938 the Trustee received $5,600.00 and during 1939 $18,650.00 from the same source. Eighty per cent of the moneys so obtained were paid to the bank by the Trustee upon order of the Court to apply on account of the principal and interest owing said bank on its said secured debt. Twenty per cent of said receipts were retained by the Trustee and used by him in payment of expenses of administration.

"10. The Trustee in Bankruptcy has endeavored at all times since his appointment to sell various properties of the bankrupt at prices commensurate with their value. Due to depressed market conditions, sales have been slow. The indebtedness of the estate is considerable and the Trustee has believed it to be to the best interest of the creditors not to sacrifice the properties by an immediate sale under the aforesaid conditions and, accordingly, has conducted a selling program which would enable him to spread his sales over a period of time and take advantage of favorable market conditions. All sales made by said Trustee were duly approved by order of Court. Pending sale, some of the unsubdivided properties, (other than the properties covered by the oil leases hereinbefore mentioned), have been rented by the Trustee mainly for agricultural purposes.

"11. It was necessary for the trustee from time to time to make repairs upon certain of the properties and to make or have made certain improvements on some properties to preserve them from hazards of fire and flood pending a sale thereof. [36]

"12. The Trustee in Bankruptcy has participated in all of the transactions set forth in his First, Second, Supplemental Second and Third Reports and Accounts filed on March 29, 1938, December 8, 1938,

December 22, 1938, and October 31, 1939, respectively. He has not engaged in the purchase or subdivision of real property nor acted as a selling agent for owners of property.

"13. No general order of the Court authorizing the Trustee to conduct the business of the bankrupt corporation or forbidding him to do so has ever been made or signed. The Court has made orders authorizing the Trustee to lease, pending sale thereof, unsubdivided lands, grant easements and rights of way to the City of Los Angeles and County of Los Angeles for street purposes, make sales of real property, cancel leases of real property, make payments upon the indebtedness of the bankrupt, compromise claims against the bankrupt, enter into agreements with the City of Long Beach, California, concerning rights to oil and gas produced under the Universal Consolidated Oil Company lease hereinbefore mentioned pending determination of title disputes to the property covered by the lease, renew contracts with the Oil Field Testing and Engineering Company, Inc. for the checking of oil and gas production on said property, and to lease, pending sale, a barn belonging to the bankrupt estate for the storage of hay." [R. 30 to 36, inclusive.]

Finding 14 is set out at pages 8, 9 and 10 of the Government's brief and is the compilation by the Collector of the receipts and disbursements of the Trustee in Bankruptcy for the years 1938 and 1939.

The agreement and supplement thereto and modifications thereof referred to in Finding 6 are found at pages 61 to 94 of the Record. These documents disclose that at the time of the execution of the original agreement the Bankrupt Corporation was indebted to Security-First National Bank of Los Angeles in a sum in excess of $1,300,000.00 [R. 62], and that this indebtedness was long overdue and was secured by approximately 90% of all of the properties of the Bankrupt Corporation. [R. 53.] The documents mentioned provided for the payment of the indebtedness so due the bank in installments over a period of approximately two and one-half years. [R. 81.] Provision was made for the liquidation of the properties, record legal title to which was held by the bank, at such prices and upon such terms and conditions as should be approved by the bank, the Trustee in Bankruptcy and the Court. Proceeds of the sale were to be paid to the bank by the Trustee in Bankruptcy after deducting expenses of sale. All contracts of sale were to be executed by the bank; all leases and rental agreements were to be executed by the bank. The Trustee in Bankruptcy, however, was authorized to keep out of any rentals collected on the properties up to $7,000.00 for the period of one year. [R. 72.] The rentals collected by the Trustee in Bankruptcy were during the years 1938 and 1939 considerably less than $7,000.00 for each of said years. [R. 37 and 38.] By agreement, however, with the bank the Trustee in Bankruptcy was permitted to retain 20% of the gross proceeds of the sale

of real properties for the purpose of paying costs of sale and expenses of administration. [R. 35.]

The Universal Consolidated Oil Company lease referred to in the Findings is to be found at pages 149 to 184 of the Record. The principal receipts of the Trustee in Bankruptcy during the years 1938 and 1939 were through oil royalties received under this lease. [R. 37 and 38.] Royalties in a small sum were received from the community oil and gas lease covering scattered lots insufficient in size to justify separate leases. [R. 34.] The fact that the amounts so received from the community oil and gas lease are comparatively insignificant is disclosed by the reports of the Trustee in Bankruptcy which are set forth in the Record, pages 94 to 138. The oil royalties so received were paid to the Security-First National Bank of Los Angeles by the Trustee in Bankruptcy to cover (1) taxes assessed against the properties, record legal title to which is held by the bank, (2) costs of engineering services for checking oil and gas production, and (3) principal and interest owing said bank. (Finding 8, *supra.*)

ARGUMENT.

I.

The Burden of Proof to Establish That the Transactions Had by the Trustee in Bankruptcy Subjected Him to Payment of Income Taxes Is Upon the Government.

Prior to 1916 a Trustee in Bankruptcy was not subject to the payment of income tax upon his receipts whether he was operating the business or property of the bankrupt or not. In 1916 the predecessor of Section 52 (a) of the Internal Revenue Act was passed by Congress in essentially the same language as the present act. Statutes imposing a tax must be construed most strongly against the Government and in favor of the citizen. In *Gould v. Gould,* 62 Law Ed. 211, it is said:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen." (Citing cases.)

In *Reinecke v. Gardner,* 72 Law Ed. 866, at page 867, it is said:

> "As under the bankruptcy act the entire property of the bankrupt vested in the trustee, the income in question was not the income of the bankrupt corporation but of the trustee and was subject to income and excess profits tax only if the statutes authorized the assessment of the tax against him. * * *
>
> "* * * A tax imposed on corporations alone does not extend to a trustee in bankruptcy of a corporation."

See also:

In the Matter of Owl Drug Co., Bankrupt, 21 Fed. Supp. 907.

II.

The Trustee in Bankruptcy, H. F. Metcalf, Was Neither Authorized to nor Did in Fact "Operate the Business or Property" of the Bankrupt Corporation.

Section 2, Subdivision (5) of the Bankruptcy Act provides:

> "Authorize the business of bankrupts to be conducted for limited periods by receivers, the marshals, or trustees, if necessary in the best interests of the estates, and allow such officers additional compensation for such services, as provided in section 48 of this Act."

No order authorizing the Trustee in Bankruptcy to conduct the business of the Bankrupt Corporation was ever made or entered. (Finding 13, *supra.*) If the Trustee in Bankruptcy could conduct the business of the corporation without authority of the Court then there was no purpose in enacting Subdivision (5) of Section 2 above mentioned. Regarding a similar provision in Chapter XI of the Bankruptcy Act this Court said in *Urban Properties Corporation v. Benson,* 116 Fed. (2d) 321, at page 323, as follows:

> "No trustee has the power to operate the business of the debtor until 'authorized' to do so by the order of the court and then he operates it 'subject to the control of the court.'"

In *In the Matter of Standard Electro-Medical Corporation, Bankrupt,* 38 A. B. R. (N. S.) 407 (Ref. N. D. Cal.), it is said:

> "In other words if, and when, a *trustee with permission of a court of bankruptcy,* has been authorized

to conduct, and has 'conducted' the bankrupt corporation's business, or has *maintained* its property 'in a manner to effect accomplishment of results appropriate to the nature of the enterprise,' or has 'put it to actual use in the business or employment for which it has been constructed,' then, and then only, and for the period during which such trustee shall so *operate* the property, or *conduct* the business of the bankrupt corporation, shall he, as such trustee, be compelled, under the revenue law in controversy, to make a return for such bankrupt corporation in the same manner and form as corporations are required to make such returns in order to enable the agent of the government—the interested Collector of Internal Revenue—to determine the amount of taxes to be paid, not by the bankrupt corporation, *but by the trustee in bankruptcy conducting the business thereof. In re Owl Drug Co.* (D. C. Nev.), 36 Am. B. R. (N. S.) 777, 21 F. Supp. 907, 910." (Italics ours.)

The duties of the Trustee in Bankruptcy are to be found in several sections of the Bankruptcy Act and in the General Orders but in particular in Section 47. This section provides in part as follows:

> "Trustees shall (1) collect and reduce to money the property of the estates for which they are trustees, under the direction of the court, and close up the estates as expeditiously as is compatible with the best interests of the parties in interest."

Section 27 provides as follows:

> "The *receiver or* trustee may, with the approval of the court, compromise any controversy arising in the administration of the estate upon such terms as he may deem for the best interest of the estate."

In *Remington on Bankruptcy,* Volume 2, 4th Edition, at pages 687 and 688, it is said:

> "The chief duty of the trustee is to make the bankrupt estate available for the benefit of the general creditors. Trustees are required to collect and reduce to money the property of estates for which they are trustees, as expeditiously as is compatible with the best interests of the parties in interest. And he must use due diligence in collecting the assets and may be charged with the value of assets lost by failure to discharge such duty."

At page 691:

> "In liquidating an estate, the trustee proceeds under the direction of the court. It is the court that is given power to cause estates to be liquidated and to close estates. This power is exercised by the appointment of a trustee who thereupon is required to proceed with the various steps which the Act requires him to take, but it must not be forgotten that he is the arm of the court, and at all times subject to the orders of the court in whatever he does."

And at page 701:

> "Trustee has a duty to preserve property which comes into his custody even if it may be subject to reclamation, and reasonable expenses of preservation may be charged against reclaimants."

In the *Matter of Heller, Hirsh & Co., Bankrupt,* 43 A. B. R. 525 (2nd Cir., 248 Fed. 208), it was held that the trustee in bankruptcy was not liable for income tax and the opinion of the Referee quoted by the Court in its decision is in part as follows (page 528):

> "The language used in subdivision (c) shows that the subdivision was not intended by Congress to

apply in the case of receivers or trustees in bankruptcy or assignees who merely marshalled and distributed the assets of an insolvent corporation among its creditors.

"In terms subdivision (c) applies only in cases where receivers or trustees in bankruptcy or assignees 'are operating the property or business of corporations' and thus may be in the receipt of a 'net income' as defined in the prior sections of the Act. I regard the quoted words as of marked significance.

"To my mind the subdivision was inserted in the Act to meet the specified case of the profitable operation of the business of a corporation by the officers mentioned; for instance, the operation of the business of a railroad corporation by receivers or the operation of the business of a manufacturing corporation by a trustee in bankruptcy, etc., etc.

"In either of such cases it is quite possible that the operation of the business might result in a net income, a result which Congress sought very properly to reach; see Scott v. Western Pacific R. R. Co., 246 Fed. Rep. 545, (C. C. A., 9th Circuit), (1917), page 548. I repeat my conviction that enacting subdivision (c) Congress had in mind the definite case so aptly described by the language used, and not the case of the officers mentioned when acting merely as liquidators."

Internal Revenue Department office decision No. 884, reported in Cumulative Bulletin No. 4, page 309, provides in part as follows:

"Article 622, Regulations 45, which provides that 'receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income

for such corporations on Form 1120, covering such year or part of a year during which they are in control * * *,' refers specifically to receivers, trustees or assignees who are operating the property or business of corporations, and it has been held that where trustees in liquidation are merely engaged in marshalling, selling and distributing the assets of a corporation they are not operating the property or business of the corporation within the contemplation of the article mentioned."

We proceed to a consideration of the transactions had by the Trustee in the light of the foregoing authorities. Such transactions may be briefly catalogued as follows:

1. Sales of real and personal properties.
2. The renting of improved and unimproved properties pending sale thereof.
3. Making necessary repairs to preserve properties, including work necessary to protect from hazards of fire and flood.
4. Negotiation and execution of oil and gas leases.
5. Negotiation and execution of agreement with City of Long Beach pending the termination of title disputes.
6. Granting of easements to public corporations.
7. Negotiation and execution of contract with Security-First National Bank of Los Angeles providing for liquidation of its secured debt and sale of properties held by it as security therefor.

As hereinbefore indicated the Bankruptcy Act itself provides that the Trustee is to collect, preserve and liqui-

date the property and assets of the bankrupt in order that the proceeds thereof may be made available to the creditors. This is his normal function as such Trustee. This liquidation, however, is to be made as expeditiously as possible compatible with the best interests of the parties. It is evident that Mr. Metcalf as such Trustee has merely performed the normal and regular duties imposed upon him by law, to wit, the preservation of the assets, the collection and liquidation thereof as expeditiously as the best interests of the parties require. None of the transactions had by him were intended to or were in fact in furtherance of business theretofore carried on by the corporation. True it is that a part of the business the corporation formerly engaged in was that of selling real estate. However, in addition thereto it was engaged in the business of buying, subdividing and improving the real estate before sale and acting as an agent or broker for the sale of real estate owned by others. None of these particular functions were exercised by the Trustee except only those of preserving the property pending sale, collecting the proceeds of rental of such properties pending sale or liquidation, and liquidating the properties as rapidly as was compatible to the best interests of the parties concerned. The functions so exercised by him, however, were as noted those normally imposed upon every Trustee in Bankruptcy.

Congress obviously in passing Section 52 (a) of the Internal Revenue Act and its predecessors did not intend to subject the Trustee to the payment of income tax upon his receipts where he was merely exercising these normal functions or duties imposed by the Bankruptcy Act upon the Trustee. Had it so intended it would have been a

simple matter to have expressly provided that the Trustee would be subject to an income tax upon all transactions had by him as such Trustee. Instead it provided that he should be liable only in the event he was operating the business or properties of the corporation. Congress is presumed to have had in mind the provisions of the Bankruptcy Act which gave to the Court jurisdiction to authorize the Trustee to carry on the business, and it seems to us to be obvious that Congress intended that the Trustee would be liable only in those instances where the Court had authorized the Trustee to carry on the business of the corporation, and pursuant to that authority the Trustee did in fact so carry on and conduct the business which was prior to bankruptcy engaged in by the corporation.

The unsoundness of the Government's position in the instant matter is emphasized by the following statement appearing on page 21 of its brief, to wit:

> "Even if the trustee had not engaged in leasing, managing and renting the properties but had merely realized income from the sale of the assets, he would be subject to the tax."

In effect the Government contends that if a sale by a Trustee in Bankruptcy of a parcel of real property was had for $100,000.00, and the cost to the bankrupt of the property sold was only $50,000.00, the Trustee would be liable for a tax on $50,000.00. Obviously there is no merit to such a contention, for if such was the law then all trustees would be liable to a tax regardless of whether or not they were operating the business or property of the bankrupt corporation. Such is not the law, however, and the exercise of the normal duties of a Trustee does not subject the Trustee to a tax regardless of the amount

of money he receives as a result of the performance of his duties as such Trustee.

Some stress is placed by the Government upon the fact that the Trustee has collected rents from some properties. It must be observed in this connection that such rentals were collected only pending a sale of the property. Certainly the Trustee cannot be charged with a tax merely because he exercises good judgment and collects such rentals as he can pending his being able to sell the property. Every Trustee is required by the very nature of his office to do likewise.

The Government has emphasized in its brief the fact that the Trustee entered into a lease for the development of such oil and gas as might underlie a portion of the property of the estate. We think that this was obviously the exercise upon the part of the Trustee of the duty imposed upon him to recover, take possession of and reduce to money all assets or potential assets. It is said in *Remington on Bankruptcy,* Volume 2 (4th Edition), page 689, that:

> "No order to collect the assets is necessary, for it is the trustee's duty to search for and try to bring in everything he believes to be assets."

The findings hereinbefore set forth disclose that there were no funds available to the Trustee with which to undertake the necessary drilling operations, but oil was believed to underlie the property. Other wells had been drilled and were producing upon adjacent property. There was danger that if drilling operations were not undertaken promptly that any oil that might underlie this property would be drained by others. *The oil was an asset if it could be captured and reduced to possession.* The only

feasible, practical method under the circumstances was to lease the property to one who would go upon the same and undertake to extract such oil as might be found; with the approval of the Court this was done. *It resulted in the preservation of an asset of the estate and the reduction of that asset to money.* For the lessee's services in drilling the well and capturing and reducing to possession the asset, to wit, the oil and gas, it was permitted by the terms of the lease to retain the oil and gas so extracted and pay to the Trustee a royalty or percentage of the proceeds obtained from the sale thereof. It is true that under the terms of the lease the Trustee might take possession of a portion of the oil, and to store it or otherwise dispose of it, but this option so granted to the Trustee was never exercised. The Trustee has actually only received oil royalties in accordance with the lease. Such royalties have been paid by the Trustee to Security-First National Bank of Los Angeles to apply on taxes. interest and principal of its secured debt. We do not see that it makes any difference whether the Trustee could or could not have taken possession of a portion of the oil produced. The action of the Trustee in entering into the lease was one prompted by common sense and in the furtherance of the duty imposed upon him by the nature of his office.

The Government has likewise emphasized in its brief the fact that the Trustee attempted to so conduct his sales of assets of the estate as to take advantage of favorable market conditions. A provision of the Bankruptcy Act hereinbefore quoted expressly provides that the liquidation by the Trustee is to be had as expeditiously as possible *compatible with the best interests of the parties.*

The Trustee is required to obtain the most from the property that he can. The interests of the creditors are not to be served by hasty, ill-timed sales. The Trustee was required to obtain a fair amount for the property, and to so conduct his selling program as to take advantage of favorable market conditions.

The contract with the Security-First National Bank of Los Angeles for liquidation of its secured indebtedness in installments over a period of years, and the sale of the property held by it as security was in furtherance of this duty of the Trustee to gain from that property all that was possible to be obtained for the benefit of the unsecured creditors, whose claims exceed $295,000.00. [R. 53.] The more rapidly the debt of the bank could be reduced the sooner unsecured creditors would expect to receive something on their claims, but the necessity of receiving a fair and adequate return from such sales could not be sacrificed for rapidity in reduction of the debt of the secured creditor. The greater the price obtained from sales of portions of the property the more chance there is of the unsecured creditors obtaining payment on their claims. A forced sale of the great number of properties involved in order to pay the debt of the secured creditors was not in the interest of unsecured creditors. Obviously therefore, the contract was just another example of the exercise of the Trustee of his normal duties and functions. This contract was approved by the Referee, the District Court and by this Court. See *In re F. P. Newport Corporation, Ltd.*, 98 Fed. (2d) 453.

Again and at the risk of repetition we repeat—that the transactions had by the Trustee and disclosed by the record herein were had pursuant to and in the exercise of

his normal duties as Trustee, and that in the exercise of such duties he was not operating the property or business theretofore operated by the corporation and there is no proof in the record in this case that the Trustee is obligated under the provisions of Section 52 (a) of the Internal Revenue Code for the payment of any tax upon his receipts as such Trustee.

In the *Matter of Owl Drug Co., Bankrupt,* 21 Fed. Supp. 907, 37-2 U. S. T. C. 10,376 and 10,377, it is said:

> "Since 1916 the yearly Revenue Acts have contained provisions identical with the one under consideration. Their object is to reach a new source of income taxation, not reached before. But income from that source is not available, unless all the conditions imposed by the section co-exist. The most fundamental one is that the receiver, trustee in bankruptcy, or assignee must be 'operating the property or business' of a corporation, and all of it.
>
> "To 'operate' means *to put into, or to continue in operation or activity, to manage, to conduct, to carry out or through.* This is both the ordinary and the legal definition of the word. (See: Webster's New International Dictionary; 6 Words and Phrases (1st series) (1904) pp. 4989 et seq.; 3 idem (2nd series) (1914) pp. 743 et seq.; 5 idem (3rd series) (1920) pp. 629 et seq.; 2 Idem (4th series) (1933) pp. 864 et seq. The new Shorter Oxford English Dictionary defines it as follows:
>
> > " 'To direct the working of, to manage, conduct, work (a railway business, etc.); to carry out, direct to an end (an undertaking, etc.); chiefly U. S. 1880.' (Volume II, p. 1374.)
>
> "The operation of a business implies its conduct and management not sporadically, but continuously

over a definite period of time, with one aim,—*profit making*. Repeatedly, when deductions have been claimed by a taxpayer for losses resulting from the claimed 'operation' of a trade or business during the taxable year, under the provisions of the various Revenue statutes, allowing such deductions, the Courts have held that the requirement of continuity and assiduity had to be satisfied. (See: *Bedell v. Commissioner of Internal Revenue* (C. C. A. 2, 1929), 30 Fed. (2) 622; *Schuette v. Anderson* (1932) (C. C. A. 2), 55 Fed. (2d) 902; and see: *State of Iowa ex rel. Gibson v. American Bonding & Casualty Co.* (D. C. Iowa, 1937), as yet unreported.)

"The business of a corporation is 'that which occupies the time, attention and labor of men for the purpose of a livelihood or profit.' (*Flint v. Stone Tracy Co.* (1910), 220 U. S. 107, 171.) Said the Court in *Von Baumbach v. Sargent Land Co.* (1917), 242 U. S. 502, 517:

> " 'It is evident, from what this court has said in dealing with the former cases, that the decision in each instance must depend upon the particular facts before the court. The fair test to be derived from a consideration of all of them is between a corporation which has reduced its activities to the owning and holding of property and the distribution of its avails and doing only the acts necessary to continue the status, and *one which is still active and is maintaining its organization for the purpose of continued efforts in the pursuit and gain and such activities as are essential to those purposes.*' "

See also:

In re Doehler Die Casting Co., Inc., et al. v. The Meadows Mfg. Co. (S. D. Ill.), U. S. T. C. 1938 Suppl., page 10,491.

Discussion of Authorities Cited by the Government.

A number of decisions of the courts have been cited in the Government's brief in support of its position. An examination of these authorities discloses that in no instance was a Trustee in Bankruptcy involved and in no instance did the Court construe Section 52 (a) of the Internal Revenue Act in relation to transactions had by a trustee in bankruptcy.

The decisions so referred to by the Government may be roughly classified as follows:

1. Those construing the act in relation to transactions had by a receiver.
2. Those construing the act in relation to transactions had by a Trustee under private trusts.
3. Those construing the Capital Stock Tax Act.
4. Those construing the general provisions of the Revenue Act imposing tax upon corporations.

We do not believe that any useful purpose would be served by a lengthy discussion of the authorities cited by the Government, but in an effort to be of some assistance to the Court we briefly refer to a few of the decisions cited.

Illustrative of the cases cited under the classification 3 above are those cited on page 13 of the Government's brief including the case of *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 61 Law Ed. 460. The Supreme Court in its decision in this matter had this to say at page 468:

> "It is evident, from what this court has said in dealing with the former cases, that the decision in

each instance must depend upon the particular facts before the court. The fair test to be derived from a consideration of all of them is between a corporation which has reduced its activities to the owning and holding of property and the distribution of its avails, and doing only the acts necessary to continue that status, and one which is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain, and such activities as are essential to those purposes."

The case of *Heiner v. Mellon,* 304 U. S. 271, does not involve a Trustee in Bankruptcy but an ordinary taxpayer who liquidated assets, and during the course of such liquidation he made a profit. Obviously a tax would be payable on such profit.

The case of *Buckley v. Commissioner,* 66 Fed. (2d) 394, involved only the question of whether or not an income tax was payable upon income received from a fund held for the benefit of a private person.

We have no quarrel with such decisions as represented by *Swarts v. Hammer,* 194 U. S. 441, holding that property in the possession of the Trustee in Bankruptcy is subject to a state property tax.

The case of *Louisville Property Co. v. Commissioner,* 47 B. T. A. No. 6, is not at all helpful for in that case it appears that in 1919 the Court of Appeals of Kentucky ordered that a receiver be appointed for the Louisville Property Co., a Kentucky corporation, for the purpose of paying up its debts and winding up its affairs. Instead of a receiver being appointed the corporation in 1919 assigned all of its assets to a trust company in trust for

the payment of its debts, expenses of administration and the distribution of the remainder, if any, to the stockholders of the corporation. In 1935 the trust company resigned and one Williams was appointed successor trustee or assignee to carry out the terms of the 1919 trust. Williams during the course of his operations carried on similar transactions theretofore carried on by the corporation except that he did not acquire new properties but pending the sale and disposition of the properties he proceeded to operate essentially in the same manner as the corporation. The Court held that he was operating the property and business of the corporation within the meaning of Section 52 of the Revenue Act of 1934 and 1936. We have no quarrel with the decision under the facts therein involved, but it is entirely foreign to the transactions had in the instant cause by Mr. Metcalf *as Trustee in Bankruptcy.*

The case of *State v. American Bonding & Cas. Co.,* 225 Iowa 638, 281 Northwestern 172, is not helpful in our opinion, since there a receiver had been appointed by the State Court. Claims presented in the receivership proceedings were large, involved and quite complicated, necessitating some litigation in order to dispose of them. In the meantime the receiver had taken possession of the assets which consisted of bonds, mortgages and securities. He sold some, reinvested the proceeds in other securities, foreclosed mortgages, invested some of the proceeds in other securities, and where the property had been acquired under the foreclosure he proceeded to manage that property. The transactions thus had by the receiver were to a large extent the same or similar to those carried on by the corporation itself prior to the receivership.

The case of *U. S. v. Trust No. B1.35,* 107 Fed. (2d) 22, involved a trust organized in corporate form, for the management of oil companies' lands; the Trustee acting under the direction of the advisory board not only handled existing leases but in order to *increase profits* made new leases and new agreements with former operators concerning production, and stored and transported oil for a special compensation. The Court held that the business trust was carrying on the very business for which it was organized, to wit, the transaction of business for profit.

Another similar case is *Kettleman Hills R. S. No. 1 v. Commissioner,* 116 Fed. (2d) 382.

The case of *U. S. v. Rayburn,* 91 Fed. (2d) 162, involved a private trust created to hold land, collect rents and profits thereof and sell the same when a favorable price could be obtained, and distribute profits thereof to former stockholders.

Several cases are cited by the Government wherein the Courts have held that under the facts involved in each particular decision the corporation was carrying on or doing business within the meaning of Section 105 (a) of the Revenue Act of 1935, imposing a capital stock tax. We have no quarrel with those decisions, but do not believe that decisions determining whether or not, under a particular set of facts, a corporation is subject to a capital stock tax are helpful in determining the issue here involved.

Trustees in Bankruptcy are not subject to the Capital Stock Tax Act or to the Excess Profits Tax Act. See *Reinecke v. Gardner,* 72 Law Ed. 866.

Many decisions can be cited wherein the Courts have held that transactions had by a corporation of a character similar to those had by the Trustee in the instant matter did not constitute carrying on business by such corporation under the Capital Stock Tax Act. We refer to a few of those decisions as follows: In the *Estate of Isaac G. Johnson v. The United States* (Court of Claims), 37 Fed. Supp. 617, it was held that a realty corporation organized to take over and manage the realty assets of a decedent was not doing business within the provisions of the Capital Stock Tax Act where it confined its activities to owning, holding and preserving its property and the collection of the income therefrom with the ultimate intent to dispose of the properties and distribute the avails and liquidate as rapidly as seemed advantageous. To like effect see *Western Shore Lumber Company v. U. S.* (N D. of Calif.), 41-2 U. S. T. C. 10,586; *McCoach v. Minehill & S. R. Co.,* 57 Law Ed. 842; *Sears, et al. Trustee v. Hassett,* 40-1 U. S. T. C. 10,225; *Nashua & Lowell R. R. Co. v. Welch,* 40-1 U. S. T. C. 9,776; *Zonne v. Minneapolis Syndicate,* 55 Law Ed. 428.

The Government has emphasized Treasury Regulations 101, Article 52-2 and Treasury Regulations 103, Section 19.52-2. It is our position that these regulations fully support our contention for it will be observed that the first portion of the regulations provides that "receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must

make returns of income *for such corporations.*" The balance of the regulations relates only to a receiver, no mention being made therein of a trustee in bankruptcy. Obviously if any income tax is due by a trustee in bankruptcy it must be by virtue of his operations of the property or business of the corporation. It is not income of the corporation in any sense of the word. It is his income only, and the regulations recognize a distinction between a Trustee in Bankruptcy and a receiver, for the regulations provide that if a receiver has full custody of or control over a business or property of a corporation he shall be deemed to be operating such business or properties, even though he be only marshalling, selling and disposing of its assets for the purpose of liquidation. There may be propriety in this regulation as directed to a receiver for a receiver has no title to the property administered by him; the property remains at all times the property of the corporation. On the contrary a Trustee in Bankruptcy acquires title. He necessarily assumes full control over the assets, and the function imposed upon him by law is to preserve, marshal and liquidate, but Congress made no provision for the exaction of a tax as a result of such transactions by a Trustee in Bankruptcy. The regulations themselves recognize this fact, and the wording of the regulations is an acknowledgment that no tax is payable by a Trustee in Bankruptcy except in the special instance where he operates the property or business formerly owned by a corporation pursuant to an order of Court.

In conclusion, we direct the Court's attention to the fact that all funds received by the Trustee in Bankruptcy were paid by him, with the exception of those used in paying expenses of administration, to the secured creditor to apply on its debt. [R. 34-35.] Since said creditor is a national bank it has undoubtedly been required to write off most of its obligations [it filed an unsecured claim for $500,000.00, R. 32], and payments made to it are probably taxable to it as a "recovery on bad debts."

We respectfully submit that the judgment of the District Court approving and affirming the Referee in Bankruptcy's findings and order disallowing the claim of the Government should be affirmed by this Court.

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